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C O N F I D E N T I A L SECTION 01 OF 02 TEL AVIV 004979

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TAGS: [ECON](#) [EFIN](#) [PGOV](#) [EAIR](#) [IS](#) [ECONOMY](#) [AND](#) [FINANCE](#) [GOI](#) [INTERNAL](#)

SUBJECT: BUDGET BATTLE BEGINS

Classified By: Deputy Chief of Mission Gene A. Cretz for reasons 1.4 (b) and (d)

1. (C) Summary: At approximately 0100 on August 10, the Israeli Cabinet approved the draft 2006 Budget by a vote of 12-8. Negotiations over budget cuts in the wake of former Finance Minister Binyamin Netanyahu's August 7 resignation took longer than expected. The two main changes to expenditures were a reduction in the cuts from the defense budget and adjustments to the level of uniform cuts for other ministries. In addition, the Cabinet made changes to the draft economic arrangements legislation (EAL) and introduced a policy that would partially liberalize the aviation sector. The EAL has served as the main vehicle for structural reform of the economy in the last few years. In light of a sobering poverty report, publicly released as the Cabinet met, Prime Minister Sharon promised to explore a negative income tax to help the poorest sectors in Israel. The budget debate will now move to the Knesset, when it reconvenes after summer recess, before the October 31 deadline. End summary.

Monitoring the Market

2. (C) At the beginning of the Cabinet discussion of the budget at 1000 August 9, PM Sharon stated unequivocally that, "The Cabinet must pass the budget today." While technically missing the deadline, the Cabinet's approval of the 2006 budget sent a message of stability before the opening of the market. The Tel Aviv Stock Exchange ended the trading day up one percent. Standard & Poor's Rating Services maintained Israel's foreign currency rating on August 10 positing that they expect fiscal and economic reform in Israel to remain on track despite recent political turbulence. President of the Bank of Israel, Stanley Fischer, stated to a local business newspaper (The Marker) that "It is very important that the government meet the deficit restrictions in its expenditures. The government has the confidence of the markets and it is forbidden that it lose that."

The Vote

3. (C) The poverty report was heralded by Labor Party Cabinet members as evidence of the need for increased social spending for the "weakest sectors." Media reports claim that Vice Premier Shimon Peres demanded NIS 1 billion (about 220 million USD) for social spending in exchange for Labor's votes. A rumor of a late afternoon offer from acting Minister of Finance Ehud Olmert for between NIS 500-600 million (over 120 million USD) increases in social spending was apparently ultimately rejected by Labor. According to media reports, the majority of the Cabinet voted along party lines (Likud in favor, Labor opposed), however Minister of Agriculture Yisrael Katz (Likud) voted against the budget, and Minister of the Environment Shalom Simhon (Labor) voted in favor. Simhon explained his break with Labor's votes by commenting to the press "As my ministry is poor, and in light of the fact that I was not the decisive vote, I agreed to back the proposal." Katz did not comment on his vote. (Note: This was Katz's second vote against the Likud in the Cabinet. He also voted August 7 against implementation of the disengagement plan. End note).

Changes to the Budget

4. (C) The primary changes in budget expenditures were a trade off between reducing cuts to the defense budget and increasing the budgets cuts of other ministries. The cuts for the Ministry of Defense budget were slated to be 1.5 billion NIS; however that figure fell to 650 million NIS after negotiations late in the evening of August 8. The other ministries were facing a total of 1.1 billion NIS in cuts, but are now forecasted to lose 2 billion NIS from their budgets. It is clear that the Minister of Health and Minister of Environment both expect to get more money in their 2006 budgets (both voted in favor of the budget). Haaretz reported on August 11 that Director of the Budget at the Ministry of Finance, Kobi Haber, planned to increase the across-the-board cuts in the budgets of ministries to seven percent (versus four and a half percent as proposed in the first draft of the budget). In addition, press reporting

claims that the MoF will cancel 500 million NIS in development assistance for the Negev.

Changes to the EAL

15. (C) The Cabinet also approved a clause in the Economic Arrangements Law that will call upon the Minister of Transportation to consult with the Ministry of Tourism, a representative of the PM's office, and the Ministry of Finance whenever a foreign air carrier wishes to alter their flight schedule. Previously, when a foreign carrier submitted an application, the Minister of Transportation in conjunction with the Civil Aviation Authority, a department of the ministry, had the sole authority to make a decision.

16. (C) In addition to aviation liberalization, a representative of the Prime Minister's office noted his intent to hold a meeting in September to discuss the introduction of a negative income tax to help deal with the income disparities highlighted in the newly released poverty report. In the past, BOI Governor Fisher has publicly supported exploring a negative income tax. The language regarding the negative income tax in the current EAL is vague.

Next Steps

17. (C) The Cabinet's approval of the budget is the first step in a long process. The budget will be presented to the Knesset when it reconvenes after summer recess, before the deadline of October 31. During the next few weeks Olmert will attempt to make changes that do not disturb the basic framework of the budget (deficit and expenditure targets), but that allocate additional money for "weaker sectors." The budget and EAL must be approved before March 31, 2006, or elections must be held.

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